

Overview of the Results of Quality Control Review for the Year Ended March 31, 2006

July 4, 2006

Japanese Institute of Certified Public Accountants

1. Objective of Quality Control Review

Quality control review performed by the Japanese Institute of Certified Public Accountants ("JICPA") was introduced as a self-regulatory system in 1999. The Certified Public Accountants Law ("CPA Law"), which was amended in 2003, requires the JICPA to conduct this quality control review and, at the same time, the Certified Public Accountants and Auditing Oversight Board ("CPA AOB") to monitor this quality control review from the period beginning April 1, 2004.

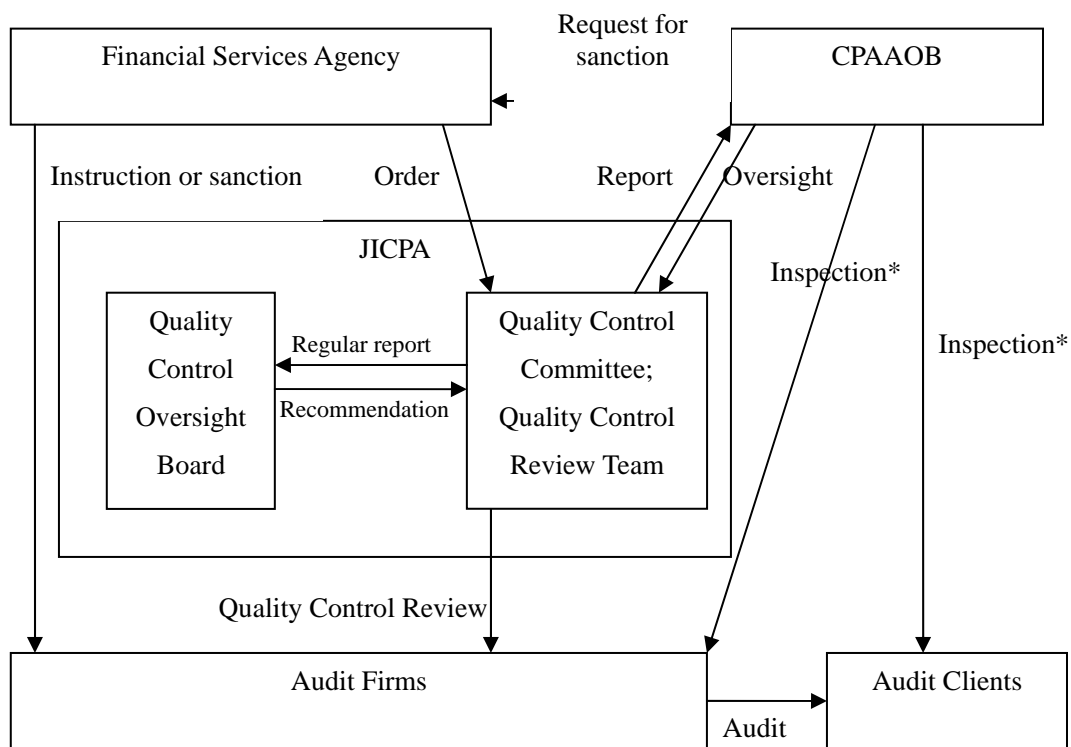
At the General Assembly meeting held on July 5, 2005, the JICPA Constitution was revised, changing the role of quality control review from the existing "directional or educational role" to simply "directional role." However, Article 87, Paragraph 1 of the JICPA Constitution states that, "The JICPA, taking into consideration the purpose of Article 46-9-2 of the CPA Law and the public interest in audits, will conduct quality control reviews of audits performed by certified public accountants or audit corporations ("audit firms"), notify them of the review results, make recommendations as necessary, and receive reports on corrective actions taken with regard to those recommendations, in order to maintain and improve an appropriate level of quality of members' audits, which lead to maintaining and ensuring public confidence in audits." Article 87, Paragraph 2 also states that, "Quality control review has a directional role and shall not be interpreted as intended to detect noncompliance or impose disciplinary actions."

As described above, rather than detecting noncompliance or imposing disciplinary actions, quality control review intends to maintain and improve audit quality as a result of independent reviews by full-time reviewers and not by the individuals involved in the audit engagement subject to the review, because the quality control review system encompasses such procedures as making recommendations, receipt of responses from audit firms regarding corrective actions to be taken in response to those recommendations, and the receipt of reports from audit firms concerning implementation of actions as a result of reviews conducted by an independent, full-time reviewer.

2. Relationship between the Structure of Quality Control Review and Monitoring by the CPAAOB

For the year ended March 31, 2006, the scope of quality control review has been extended to audit firms that perform audits of entities stated in Article 87, Paragraph 3 of the Constitution, that is, certain large companies and other entities stipulated in the amended CPA Law. Therefore, we have enhanced the review structure by increasing the number of reviewers and members of the Quality Control Committee in order to handle the increased number of audit firms subject to quality control review. From April until the end of September 2005, the number of reviewers increased continuously to 20, including IT professionals. The number of reviewers has remained at 20 for the balance of the year. In addition, since July 2005, two deputy chief reviewers have been assigned to reinforce the management of the review staff.

The following chart illustrates the structure of quality control review and monitoring by the CPAAOB:



*If necessary

3. Overview of Quality Control Reviews Conducted for the Year Ended March 31, 2006

The following table indicates the number of audit firms which were subject to quality control reviews conducted for the year from April 1, 2005 to March 31, 2006 and to which quality control review reports and recommendation reports for improvement were issued.

	Number of quality control reviews conducted for the year		Number of quality control review reports and recommendation reports issued for the year			
	Planned	Actual	Brought forward	Quality control review reports	Recommendation reports	Carried forward
Audit corporations	70	70	4	66	67	7
Sole practitioners	70	70	5	73	72	2
Total	140	140	9	139	139	9

Notes:

1. Since the year beginning April 1, 2005, the scope of quality control review has been extended to audit firms that perform audits of entities stated in Article 87, Paragraph 3 of the Constitution, that is, certain large companies and other entities stipulated in the amended CPA Law. Therefore, the actual number of quality control reviews conducted this year has significantly increased compared with the prior year's 94 audit firms.
2. The actual number of quality control reviews conducted during the year was as originally planned. However, there were eight changes in audit firms subject to reviews, as follows:
 - Addition of one new audit corporation in response to the Chairman and President's Statement issued on October 25, 2005;
 - Increase of seven new firms (seven sole practitioners and no audit corporations) as a result of their appointment as independent auditors of certain large companies and other entities, and for other specific reasons that were identified;
 - Decrease of eight firms (one audit corporation and seven sole practitioners) due to their resignation as independent auditors of certain large companies and other entities, and for other specific reasons that were identified.
3. The reasons for discrepancies between the number of quality control review reports issued and the number of recommendation reports issued are:

- A quality control review report was not issued to an audit corporation that became subject to review as an additional firm this year, based on the reason explained in Note 2. With regard to this audit corporation, only a limited review was conducted this year, and a full scope quality control review will be conducted next year;
 - A recommendation report was not issued to a certain sole practitioner because there were no recommendations necessary.
4. Both a quality control review report and a recommendation report were issued to one audit corporation that was established this year by CPAs who left another audit corporation that was subject to a quality control review during the year. However, these reports are not included in the above numbers of quality control review reports and recommendation reports issued for the year.
 5. Nine audit firm reviews were carried forward to the following year and continued to be under examination by the Quality Control Committee as of March 31, 2006.

4. Focuses for This Period

With reference to the recommendations from the Quality Control Oversight Board in the previous year and from the CPAAOB through its monitoring process, we established the following items on which to focus for the quality control reviews of this year. These key focus items were announced to members in the September 2005 issue of the JICPA Newsletter.

4-1. Auditor independence

In response to the requirements of auditor independence as enhanced by the amended CPA Law, the JICPA issued a revised Code of Ethics and implementation guidance with regard to independence. The Ethics Committee of the JICPA also published a *Checklist of Auditor Independence* as Research Report No. 1 in March 2005.

In the quality control review program this year, the Review Team will evaluate whether an audit firm ascertains the independence of its partners and audit personnel with the checklist described above, or, when an audit firm ascertains independence using a different manner, whether all the necessary items have been ascertained.

4-2. Follow-up of recommendations

As a result of the quality control reviews conducted last year, some audit firms were identified as not properly implementing corrective actions from recommendations made in the previous quality control review. Reports on implementation of quality control received during the period ended March 2005 also revealed that some audit firms had not fully implemented corrective actions in response to the recommendations.

The following procedures will be taken to promote improvement in response to the circumstances described above:

- a. To better understand the situation and require prompt improvement, the Review Team should visit those audit firms that do not respond with "completed" in their report on the implementation of quality control review recommendations undertaken as a result of the quality control review performed in the prior period.
- b. The Review Team should inquire as to the reasons, require prompt improvement, and report to the Quality Control Committee when the quality control review for this period identifies that an audit firm's implementation is not satisfactory for matters which were reported as "completed," or were reported that the improvements "would be completed by the end of March 2005" in the firm's report on implementation of quality control review for the year ended March 31, 2005.

4-3. Risk-based approach

Although significant deficiencies are decreasing in audits based on risk assessment, many matters were identified in reviews related to the planning and performing of procedures for control risk assessment and the determination of substantive procedures based on the assessed risk.

The Review Team will carefully examine whether an audit firm has established policies and procedures that will ensure control assessment procedures and substantive procedures based on the assessed risk are properly performed. It should be noted that a revised review tool (QCP400) for this period requires documentation of the description of any findings for each item. QCP400 has also been revised in the area of the auditor's assessment of control risk regarding information systems using information technology (IT). If an audit firm is considered to have not completed corrective actions for the recommendations resulting from the previous review, the Review Team will require the audit firm to analyze the reasons and eliminate the factors that prevent full implementation.

After consideration of the reports on implementation of quality control for the period ended March 2005, some audit firms who became subject to quality control review as of last year have not yet established policies and procedures for audits using the risk-based approach. Therefore, the Review Team will examine whether those audit firms assess the risks of audit clients and perform audit procedures based on the assessed risks.

4-4. Engagement quality control reviews for expressing an audit opinion and monitoring

Evaluations of reports on implementation of quality control have disclosed that some audit firms which became subject to quality control review as of last year have not yet established policies and procedures requiring an engagement quality control review, and that some deficiencies in implementation of engagement quality control reviews were identified for audit firms which previously have been subject to quality control reviews.

The Review Team will carefully evaluate in the course of the quality control reviews this year whether an independent, competent, and qualified quality control reviewer implements engagement quality control reviews before expressing an audit opinion. The review tools as revised this year with added procedures should be utilized, including: inquiries whether an audit firm ensures that an engagement quality control reviewer is independent from the reviewed audit client (QCQ220), analysis of time spent on an engagement quality control review (QCQ400), and evaluation of the scope of documents to be reviewed by the engagement quality control reviewer (QCP400).

Article 3, Paragraph 4 of the Cabinet Office Ordinance regarding audit corporations requires an audit corporation to establish a system that monitors compliance with the audit firm's policies and procedures that ensure proper audit engagements and engagement quality control reviews. The Review Team should be aware of the need for careful examination as to whether proper monitoring has been implemented in the quality control review of audit corporations.

4-5. Sufficiency of audit procedures in forming an audit opinion

In a stage of advance preparation, the Review Team will review annual securities reports and documents received from an audit firm in particular, matters relating to audit procedures of accounting estimates included in QCQ400, VII. *Documents Relating to Significant Matters Serving as References for the Review*. Subsequently, the Review Team will evaluate whether an auditor performed sufficient appropriate audit procedures, and properly documented in working papers the procedures performed and conclusions reached, with regard to significant audit items and matters that are considered high risk. The Review Team will also ascertain whether matters to be considered and matters to be corrected are appropriately considered and summarized, and that significant matters are included as the subjects of an engagement quality control review.

4-6. Audit engagements of certain large companies and other entities by a sole practitioner, including joint audit arrangements and audit engagements when an auditor has been long associated with an audit client

From the year ended March 31, 2006, audit firms are required to provide information on the number of years of a partner's association with each audit client that is subject to quality control review in the list of audit engagements submitted to the Quality Control Review Team. When an audit engagement having a long association by a single partner becomes subject to quality control review, the Review Team will perform reviews with professional skepticism, noting that threats to independence are likely to grow in such circumstances.

With respect to audit engagements of a sole practitioner, most of which are joint audit arrangements by two or more CPAs, the Review Team will examine whether the terms of the agreement among auditors are clearly documented, whether written confirmations of the independence of joint auditors have been obtained, and whether the reviews of audit documentation are properly conducted and such documentation is appropriately retained.

(Review results relating to the focus areas for the period)

4-1. Auditor independence

Recommendations were made to 63 audit firms. Previously issued recommendations were repeated to eight of these firms, and improvements were required of the remainder. Twelve of these audit firms were newly subject to quality control review beginning this period. Most of the recommendations were matters regarding written confirmation of independence, and responses were obtained from the audit firms receiving this recommendation that they would improve their practices regarding this matter immediately.

4-2. Follow-up of recommendations

The Review Team visited 35 audit firms to which were issued quality control review reports with a qualifying conclusion resulting from the prior quality control review and were also subject to quality control reviews this period. It was required for those audit firms to improve without delay the identified deficiencies by implementation of corrective actions.

Through reviews of reports on implementation of quality control submitted in this period by audit firms subject to quality control reviews during the prior period, results indicated that by March 31, 2006, some audit firms did not include in their plans the complete implementation of corrective actions for the development of audit plans based on a risk-based approach and assessment of control risks related to information systems using IT. However, those audit firms were not visited during this period, taking into consideration that the new and revised Auditing Standards Committee Statements would only become effective from periods beginning on or

after April 1, 2006, and that new IT expert support by the JICPA would be implemented during this period.

The results of quality control reviews during this period indicated that some of the implementations were assessed as continuing to be unsatisfactory, although these audit firms had reported in their reports submitted during the previous year regarding implementation of quality control that either implementation was already completed, or would be completed by March 2005. In Item 8, "Overview of Recommendation Reports Issued for the Current Period," these cases are included in the table at 8-1 under the column headings, "Recurring." Identification of the reasons for unsatisfactory implementation and prompt improvements for recurring recommendations are required for such audit firms (See below "Risk-based approach")

4-3. Risk-based approach

Recommendations were made to 114 audit firms, 76 of which received the same recommendations as previously. These results indicate that many audit firms still have deficiencies regarding this matter. If a firm has received repeated recommendations as in prior years, identification of the reasons for unsatisfactory implementation as well as prompt improvement is required. Major reasons for unsatisfactory improvements include inadequate understanding of the requirements of Auditing Standards Committee Statements and other pronouncements, and failure to implement corrective actions fully, in spite of ongoing efforts. Therefore, further improvements are needed at audit firms.

These 114 audit firms include 18 audit firms that were newly subject to a quality control review beginning this period. As described below under Item 8-2(a), "Overview of Recommendation Reports Issued for the Current Period," many findings were regarding matters of planning and performing of procedures designed for control risk assessment and the determination of substantive procedures based on the assessed risk. In addition, a sharp increase was observed in the number of recommendations for control risk assessment of information systems using IT, mainly as a result of the development of our review tools for this area, and reviews conducted by the JICPA's IT professional.

For periods beginning on or after April 1, 2006, new Auditing Standards Committee Statements Nos. 27 through 31 and revised Statement No. 5 have taken effect. Audit firms need to confirm whether their policies and procedures in relation to quality control are appropriately revised in accordance with these standards.

4-4. Engagement quality control reviews for expressing an audit opinion and monitoring

a. Engagement quality control review for expressing an audit opinion

Recommendations were made to 86 audit firms. The same recommendations as in prior years were repeated to 15 of these firms, and improvements were required of the remainder. The enhancement of our review tools may have contributed to the increase in recommendations for items covered by engagement quality control reviews. Of these 86 audit firms, 17 were newly subject to a quality control review during this period.

b. Monitoring of implementation of quality control

Recommendations were made to 46 audit firms. The same recommendations as in prior years were repeated to 21 of these firms, and improvements were required of the remainder. All but one of these 46 audit firms were audit corporations. Judging from the fact that a total of 66 audit corporations were subject to a quality control review during this period, the percentage of recommendations issued in relation to this matter is quite high. The Cabinet Office Ordinance on Audit Corporations requires the establishment of a system of monitoring.

Under paragraph 78 of Quality Control Standards Committee Statement No. 1, "Quality Control for Firms that Perform Audits," which took effect for periods beginning on or after April 1, 2006, all audit firms, including sole practitioners, are required to establish policies and procedures that enable ongoing monitoring of a firm's quality control system. This replaces the "inspection" referred to in Auditing Standards Committee Statement No. 12. It should also be noted that Paragraph 83 of the Statement requires that the person who performs the periodic monitoring of a particular audit engagement should not perform the audit, nor be involved in the engagement quality control review.

4-5. Sufficiency of audit procedures in forming an audit opinion

Recommendations on audit procedures of accounting estimates were made to 71 audit firms. Recommendations for preparation of a summary of audit findings were issued to 20 audit firms. Of these 71 and 20 audit firms, 10 and 2 audit firms, respectively, were newly subject to a quality control review this period. The percentage of audit firms that received recommendations on audit procedures of accounting estimates was higher than expected.

4-6. Audit engagements of certain large companies and other entities by a sole practitioner, including joint audit arrangements and audit engagements when an auditor has been long associated with an audit client

Each review was conducted with careful consideration of whether doubts about independence have arisen from an auditor's long association with a particular audit client. As to the number of recommendations made to sole practitioners, please refer to Item 8, "Overview of

Recommendation Reports Issued for the Current Period." Recommendations on joint audit arrangements were made to 16 audit firms.

5. Significant Issues Identified in Quality Control Reviews

Quality control review reports for which a qualified conclusion or a negative conclusion was expressed were issued to 59 and 4 audit firms, respectively. Matters that led to such a conclusion include the risk-based approach (50 audit firms), engagement quality control review for expressing an audit opinion (36 audit firms), and audit procedures of accounting estimates (9 audit firms). Please refer to Item 8, "Overview of Recommendation Reports Issued for the Current Period." A disclaimer of conclusion was not expressed for the current-period quality control reviews, as was also the case in the prior period.

There were some cases that the Quality Control Committee reported to the Chairman and President pursuant to Item 5 of the Quality Control Review Standards after the Committee identified a substantial doubt regarding the appropriateness of an audit opinion expressed by a sole practitioner or an audit corporation, as stipulated in Paragraph 3 of Article 88 of the Constitution, which were discovered as a result of a quality control review. Details are as follows:

- Three cases related to four audit firms that were issued quality control review reports with a qualified conclusion; and
- Three cases related to four audit firms that were issued quality control review reports with a negative conclusion.

Matters related to audit procedures of accounting estimates, engagement quality control reviews for expressing an audit opinion, and illegal acts were reported to the Chairman and President regarding the above cases.

The Committee also identified one case to be reported to the Chairman and President that was considered a significant matter as described in Item 3 (5) 4 of the Quality Control Review Standards, although this issue was not presented in the conclusion of the quality control review report.

6. Responses to Recommendations from the Quality Control Oversight Board

In response to "Recommendations for Activities of the Quality Control Committee for the year ended March 31, 2005" which was received on June 16, 2005, the Quality Control Committee and other relevant committees of the JICPA have taken the following steps:

Recommendation 1 – Enhancement of auditor independence

● Recommendation

The Quality Control Committee should confirm that audit firms establish policies and procedures adequately responsive to the enhancement of auditor independence in the amended CPA Law.

● Responses

The Quality Control Committee revised its review tools. Based on Research Report No. 1 *Checklist of Auditor Independence* issued by the Ethics Committee, the Quality Control Committee added items to the *Procedures for Review of the Compliance with a Quality Control System* (QCP200, QCP210) and to the *Procedures for Interviews with Auditors and Personnel Engaged in Audits* (QCP300) to be utilized in quality control reviews this year. In addition, the independence of an auditor has been set as one focal point of quality control reviews this year. The review results are described above in Item 4, "Focuses for This Period," under parts of "Review results relating to the focus areas for the period"

In response to public scrutiny about auditor independence in the alleged fraudulent accounting of Kanebo, on September 16, 2005, the JICPA Chairman and President issued an announcement entitled, *On the alleged fraudulent accounting at Kanebo*. In this release, the Chairman and President urged JICPA members to recognize once again their independence as auditors in their relationship with audit clients and to ask themselves whether they maintain their independence of mind as rigorously as their independence in appearance. In addition, on October 25, 2005 the JICPA Chairman and President issued a statement entitled, *Toward the restoration of confidence in audits by CPAs*. In this statement, the Chairman and President expressed the JICPA commitment to requests for the review of partner rotations in Big 4 audit corporations, elimination of the influence of a predecessor engagement partner during the cooling-off period, compulsory training in relation to ethics of CPAs (in particular, the ethic of independence) and in the quality control of audits, and, responses to unreasonably low audit fees.

In response to the Chairman and President's Statement referred to above, Note 11-2 to Article 14 of the Code of Ethics was revised on February 16, 2006 to add an example of a relationship and appearance that may lead to doubts about the independence of an auditor. Included is the situation of a lead audit partner of an audit corporation of a specific size who has been involved in the audit engagements of a listed entity for five consecutive accounting periods, but before five consecutive cooling-off periods have elapsed, the partner is again involved in the same audit engagement. This also applies to an engagement quality control reviewer. In accordance with

this revision, the Interpretation of Independence prescribed in the Code of Ethics (Article 14) was also revised, applicable for audits covering fiscal periods beginning April 1, 2006 and thereafter.

Recommendation 2 – Risk-based approach

● Recommendation

Although significant deficiencies in the audits based on risk assessment are decreasing, many matters were identified in quality control reviews relating to the planning and performing of procedures for control risk assessment based on a preliminary assessment of control risk and the determination of substantive procedures based on the assessed risk.

The Review Team should consider carefully whether an audit firm has established policies and procedures that ensure proper performance of control assessment procedures and substantive procedures responsive to the assessed risk. If an audit firm's implementation is considered unsatisfactory, the Review Team should require the audit firm to analyze the reasons and eliminate the factors that prevent implementation.

● Responses

As described in Item 4, the risk-based approach was also set as another focus of quality control reviews for this year. The review results are described under Item 4, "Focuses for This Period" under 4-3, "The review results relating to the focus areas for this period."

The JICPA also held nationwide seminars in August 2005 on Auditing Standards Committee Report No. 27, *Audit Planning*; No. 28, *Audit Risk*; No. 29, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*; No. 30, *Auditor's Procedures in Response to Assessed Risks*; No. 31, *Audit Evidence*; and No. 5, *Audit Risk and Materiality (Revised)* which were issued on March 31, 2005 (final amendments were added March 30, 2006) and effective for years beginning on or after April 1, 2006 (early application is permitted).

In response to the abovementioned Auditing Standards Committee Reports, IT Committee Statement No. 3, *Auditor's Assessment of the Risks of Material Misstatement and Procedures in Response to Assessed Risks Related to Information Systems Using Information Technology in an Audit of Financial Statements* was issued on July 6, 2005 (final amendments were added March 17, 2006). The JICPA held two-day seminars on this Statement in October and December 2005. In addition, on March 17, 2006, the JICPA issued IT Committee Research Report No. 31 entitled, *Q&A for IT Committee Statement No. 3, "Auditor's Assessment of the Risks of Material*

Misstatement and Procedures in Response to Assessed Risks Related to Information Systems Using Information Technology in an Audit of Financial Statements" in order to serve the better understanding by CPAs of IT Committee Statement No. 3. Furthermore, IT expert support was initiated by the JICPA with the aim of providing direct assistance to facilitate the implementation of IT Committee Statement No. 3, as well as to contribute to the development of the infrastructure of the accountancy industry. This IT expert support by the JICPA consists of two components: referrals to an IT expert, and the creation of Audit IT Consultation. A seminar on this new arrangement was held in February 2006.

Recommendation 3 – Audit procedures of accounting estimates

- Recommendation

Recommendations related to accounting estimates are increasing. The Quality Control Committee should promote improvement to ensure that audit procedures of accounting estimates are properly performed.

- Response

As described in Item 4, audit procedures of accounting estimates were included in *Sufficiency of Audit Procedures in Forming an Audit Opinion* as a focus of quality control reviews this year. The review results are described in Item 4, "Focuses for This Period" under 4-5, "Review results relating to the focus areas for this period."

Recommendation 4 – Follow-up of recommendations

- Recommendation

To make use of reports on implementations of quality control that were implemented in 2004, the Quality Control Committee should follow-up the improvements resulting from recommendations on a continuing basis.

- Response

As described in Item 4, follow-up of recommendations was also set as a focus of the quality control reviews for this year. The review results are described in Item 4, "Focuses for This Period" under 4-2, "Review results relating to the focus areas for this period."

Recommendation 5 – System of quality control established by small- and medium-sized audit firms

● Recommendation

Audit firms and the JICPA should make further efforts to enable small- and medium-sized audit firms with limited resources to establish a system of quality control, including engagement quality control reviews and monitoring, before expressing an audit opinion.

● Response

At the General Assembly meeting held on July 5, 2005, the JICPA Constitution was revised to establish the Committee for Small- and Medium-Sized Practitioners as a standing committee. The Committee started its activities on October 6, 2005 and considers the necessary means of applying a quality control system in ways suitable to small- and medium-sized practitioners. The JICPA held interactive meetings three times during November and December 2005 to discuss CPA audits. At the meetings, the recent situation surrounding the accounting profession was communicated and views on further responses were exchanged.

The measures described above will serve to maintain and improve the quality of audit work.

7. Reporting to the CPAAOB

The Quality Control Committee responded to the CPAAOB, which monitors the results of the JICPA quality control reviews, as follows:

7-1. Submitted to the CPAAOB the annual report on quality control review for the year ended March 31, 2005 and monthly reports from April 2005 through March 2006, pursuant to the Cabinet Office Ordinance related to the JICPA. These monthly reports were accompanied by copies of quality control review reports, recommendation reports, and responses from members for each month.

7-2. Submitted review working papers that the CPAAOB considered necessary, and replied to inquiries from the CPAAOB;

7-3. Received on May 25, 2005 notification of the inspection results conducted by the CPAAOB from March 23 through 25, 2005. The Quality Control Committee considered what corrective actions could be taken to address the matters identified as requiring improvement. The Committee summarized its considerations as *Corrective Actions to Address the Inspection*

Results, reported them to the CPAAOB on June 24, 2005, and published them in the JICPA Journal, September 2005 issue.

7-4. Reflected the findings and recommendations from the CPAAOB in revisions of the Standard of Quality Control Review, the Procedures of Quality Control Review and the review tools. Please refer to Item 10-5, "Amendment of the Quality Control Review Procedures" and Item 11, "Development and Amendment of Review Tools."

7-5. Added one audit corporation to be subject to a quality control review for the current period based on the policy of urgent implementation of quality control reviews for Big 4 audit corporations and of overall cooperation in monitoring by the CPAAOB, as expressed in the Chairman and President's Statement, *Toward the Restoration of Confidence in Audits by CPAs* issued on October 25, 2005.

8. Overview of Recommendation Reports Issued for the Current Period

The numbers of recommendations by item and content for the current period are as follows:

8-1. Number of recommendations by item

(Number of audit firms)

	Audit corporations		Sole practitioners		Total	
	Recom- menda- tions	Recurring (included in Recom- menda- tions)	Recom- menda- tions	Recurring (included in Recom- menda- tions)	Recom- menda- tions	Recurring (included in Recom- menda- tions)
Audit engagements						
Risk-based approach	54 (26)	42 (20)	60 (24)	34 (7)	114 (50)	76 (27)
Assessing control risks in relation to use of information technology	42	2	43	0	85	2
Discussion with management and communication with corporate statutory auditors or their equivalent	38	0	41	0	79	0

	Audit corporations		Sole practitioners		Total	
	Recom- menda- tions	Recurring (included in Recom- menda- tions)	Recom- menda- tions	Recurring (included in Recom- menda- tions)	Recom- menda- tions	Recurring (included in Recom- menda- tions)
Audit procedures of accounting estimates	32 (3)	5 (0)	39 (6)	5 (1)	71 (9)	10 (1)
Development of audit manuals	15	2	1	0	16	2
Instructions to members of engagement teams	22 (0)	4 (0)	19 (2)	5 (0)	41 (2)	9 (0)
Development and maintenance of audit work papers	41 (0)	11 (0)	36 (2)	12 (0)	77 (2)	23 (0)
Preparation of summary of audit findings	11 (0)	1 (0)	9 (2)	5 (0)	20 (2)	6 (0)
Written confirmations from management	38	1	31	4	69	5
External confirmations	39 (1)	9 (0)	33 (0)	2 (0)	72 (1)	11 (0)
Other						
Engagement quality control review for expressing an audit opinion	46 (11)	9 (3)	40 (25)	6 (6)	86 (36)	15 (9)
Qualification of auditors and personnel engaged in audits	29 (2)	5 (0)	34 (2)	3 (0)	63 (4)	8 (0)
Acceptance and continuance of audit engagements	39 (0)	12 (0)	29 (2)	5 (0)	68 (2)	17 (0)
Joint audit arrangements	4 (0)	0 (0)	16 (1)	5 (0)	20 (1)	5 (0)
Monitoring of implementation of quality control	45	21	1	0	46	21
Number of quality control review reports	66		73		139	

Notes:

1. The figures in parenthesis in the table indicate the number of qualified items that led to a qualified conclusion or a negative conclusion in the quality control review reports.
2. The table indicates that qualified conclusions or negative conclusions were expressed to 35% (50/139) of audit firms on a risk-based approach and 25% (36/139) of audit firms on an engagement quality control review for expressing an audit opinion. These do not indicate that 35% or 25% of audit engagements received qualified conclusions or negative conclusions, but rather that the audit firms themselves received qualified conclusions or negative conclusions regarding their quality control review.
3. With respect to quality control reviews of sole practitioners who have a limited number of audit engagements, the conclusion for the implementation of a quality control system is drawn mainly from the results of reviewing the performance of each audit engagement. This resulted in a small number of recommendations made to sole practitioners for the development of audit manuals and monitoring implementation of quality control.

8-2. Major items of recommendation

Details of the risk-based approach, audit procedures of accounting estimates, and engagement quality control review for expressing an audit opinion are illustrated as follows:

a. Risk-based approach

	(Number of audit firms)		
	Audit corporations	Sole practitioners	Total
Setting criteria for materiality	34 (22)	25 (16)	59 (38)
Assessing inherent risks	27 (19)	25 (19)	52 (38)
Assessing preliminary control risks	33 (23)	27 (22)	60 (45)
Planning and performing tests of controls	51 (25)	44 (23)	95 (48)
Determining substantive procedures	46 (24)	46 (24)	92 (48)
Consistency and reasonableness of the overall plan	11 (4)	4 (2)	15 (6)

Notes:

1. The figures in parenthesis indicate the number of qualified items that led to a qualified conclusion or a negative conclusion in the quality control review reports.
2. As there are multiple recommendations to individual audit firms, the total recommendations do not correspond to the number of recommendations indicated in the above table under Item 8-1, "Number of recommendations by item."
3. The determination of qualified items is based on an overall consideration of the issues. Qualified items are not determined by each individual classification.

b. Audit procedures of accounting estimates

The balance sheet item, "employee retirement benefits" includes necessary audit procedures such as external confirmations in order to examine the appropriateness of basic data used in the accounting estimate.

(Number of audit firms)

	Audit corporations	Sole practitioners	Total
Deferred tax assets	20 (2)	19 (1)	39 (3)
Employee retirement benefits	25	23	48
Allowance for doubtful accounts	7 (2)	18 (6)	25 (8)
Investments in affiliates or unlisted entities	16 (2)	11 (0)	27 (2)
Slow-moving inventory	5 (1)	5 (1)	10 (2)
Property held for sale	3	0	3
Other	4	4	8

Note:

Please refer to Notes 1 and 2 of Item 8-2(a) above, "Risk-based approach."

c. Engagement quality control review for expressing an audit opinion

The classification, "Lack of adequate items to be reviewed" includes many cases where a set of engagement quality control review documents did not include financial statements subject to audit or audit plans. The classification, "Inadequate documentation of engagement quality control reviews" includes a number of cases where the conclusion of the engagement quality control review was not clearly documented.

(Number of audit firms)

	Audit corporations	Sole practitioners	Total
Lack of an adequate engagement quality control review system	21 (2)	2 (2)	23 (4)
Lack of engagement quality control reviews of semi-annual audits	2 (2)	8 (8)	10 (10)
Lack of engagement quality control reviews of audits under the Commercial Code	1 (1)	8 (8)	9 (9)
Lack of engagement quality control reviews of (annual) audits under the Securities and Exchange Law	3 (3)	3 (3)	6 (6)
Lack of adequate items to be reviewed	26	20	46
Inadequate documentation of engagement quality control reviews	23 (0)	6 (1)	29 (1)
Engagement quality control reviews after an audit opinion was expressed	3 (3)	10 (10)	13 (13)
Other	1 (1)	0 (0)	1 (1)

Notes:

1. Please refer to Notes 1 and 2 of Item 8-2(a) "Risk-based approach."
2. With respect to quality control reviews for sole practitioners who have a limited number of audit engagements, engagement quality control reviews of each audit engagement are mainly considered during the review, rather than the system of engagement quality control reviews. This resulted in no recommendations made to sole practitioners for lack of an adequate engagement quality control review system.

9. Overview of Reports on Implementation of Quality Controls

9-1. Submission of "Reports on implementation of quality controls"

In accordance with Article 3-2 of the Quality Control Committee regulations, audit firms which perform audits of entities stated in Article 87, Paragraph 3 of the Constitution (certain large companies and other entities stipulated in the amended CPA Law) are required to report by December 31 of every year on implementation of quality controls for each year ended September 30, in the form, "Reports on implementation of quality controls."

The number of audit firms that submitted reports on implementation of quality controls for the current period is as follows:

(Number of audit firms)

	Existing firms		New firms	
	Number of firms	Reports submitted	Number of firms	Reports submitted
Audit corporations	129	129	8	8
Sole practitioners	261	261	42	42
Total	390	390	50	50

There were no audit firms that did not submit reports on the implementation of quality controls.

The following table lists the breakdown of submitted reports, classified by the period in which quality control reviews were conducted.

(Number of audit firms)

Period ended March 31	Number of firms	Reports submitted
(Audit firms subject to quality control reviews)		
2005 and 2004	133	133
2006	132	132
Subtotal	265	265
(Audit firms not subject to quality control reviews)		
Subject to review from 2005	125	125
Subject to review from 2006	50	50
Subtotal	175	175
Total	440	440

Notes:

1. The difference between the above figure of 132 firms and the figure of 140 firms shown in Item 3, "Overview of Quality Control Review Conducted for the Year Ended March 31, 2006" represents eight audit firms. These firms were originally subject to a quality control review in

the current period, but were excluded as subjects of a review due to the termination of an agreement or the establishment of a new audit corporation.

9-2. Improvement of audit firms which were subject to quality control review

a. Audit firms which were subject to quality control review in the current period

Implementations of corrective actions are examined as part of the quality control review and recommendation reports are delivered if further improvements are necessary. Additional details and the degree that improvements were achieved, including the number of recurring recommendations, are described in Item 8, "Overview of Recommendation Reports Issued for the Current Period."

b. Audit firms that were subject to quality control review for the year ended March 31, 2004 and 2005

The following table indicates an analysis of corrective actions that were reported as "to be implemented." In reviewing the implementation of corrective actions, the Review Team visited 35 audit firms, including two audit firms newly subject to quality control review, as each of these two were appointed as joint auditor with an existing audit firm under review.

(Number of audit firms)

	All corrective actions implemented	A portion of corrective actions implemented	No corrective actions implemented	Total
Audit corporations	38	21	0	59
Sole practitioners	35	35	0	70
Total	73	56	0	129

Note:

The difference between the total of 129 in the above table and the figure of 133 that is shown in Item 9-1, "Submission of reports on implementation of quality controls" conducted for the years ended March 31, 2004 and 2005, is due to four audit firms not receiving recommendation reports, as no specific matters subject to recommendation were found in the course of the quality control review.

Implementations of corrective action for major recommendations are reported as follows
(compared with the previous year):

(Number of audit firms)

	Year ended March 31			
	2004		2005	
	Implemented	Not implemented	Implemented	Not implemented
Audit engagements				
Risk-based approach	109 (80)	43 (41)	107 (50)	18 (15)
Audit procedures of accounting estimates	33 (3)	2 (1)	63 (2)	3 (0)
Development of audit manuals	14	10	22	3
Instructions to members of engagement teams	20	11	37	12
Development and maintenance of audit work papers	98	10	89	7
Preparation of summary of audit findings	27 (1)	0 (0)	20 (0)	3 (0)
External confirmations	50	3	71	2
Other				
Engagement quality control review for expressing an audit opinion	80 (52)	6 (4)	64 (26)	1 (0)
Qualification of auditors and personnel engaged in audits	33	1	39	2
Acceptance and continuance of audit engagements	40	15	26	1
Monitoring of implementations of quality control	33	16	38	5

Notes:

1. The figures in parenthesis indicate the number of qualified items that led to a qualified conclusion in a quality control review report.
2. The figures in the 2004 column show the number of corrective actions implemented as of September 30, 2004 by audit firms subject to quality control review for the years ended March 31, 2003 and 2004. Similarly, the figures in the 2005 column show the number of corrective actions implemented as of

September 30, 2005 by audit firms subject to quality control review for the years ended March 31, 2004 and 2005.

9-3. Audit firms which were not subject to quality control review

- a. Quality control reviews were not conducted of 50 audit firms (8 audit corporations and 42 sole practitioners) among the audit firms that were newly subject to quality control review for the year ended March 31, 2006. Responses to questionnaires obtained from those audit firms were analyzed regarding the firm's quality control system (QCQ200, QCQ220).
- b. Quality control reviews were not conducted at 102 of 125 audit firms newly subject to quality control review for the year ended March 31, 2005. Submission of reports on implementation of corrective actions was required once again for specific items included in quality control system questionnaires (QCQ220). Based on analyses of these reports, audit firms in the following circumstances will be subject to quality control review for the year ending March 31, 2007:
 - There is a reason to conclude that only one partner is involved in audit engagements;
 - Engagement quality control reviews may not be in place; or
 - Answers to three (or more) items out of five are "No" to questions that are repeated from prior years.

10. Amendment of the Constitution, Regulations, Detailed Rules, Quality Control Review Standards, Quality Control Review Procedures, and Administrative Manual of the Committee

10-1. Amendment of the Constitution

At the General Assembly meeting held on July 5, 2005, amendment of the Constitution was resolved (effective August 11, 2005), to amend the role of quality control review from "directional or educational" to "directional" (Paragraphs 1 and 2 of Article 87). The Quality Control Committee had been required to report the facts to the Chairman and President when it identifies substantial doubt about the appropriateness of an audit opinion expressed by a CPA or an audit corporation (Paragraph 3 of Article 88). In addition to this, the Constitution was amended so that the Chairman and President could direct the Quality Control Committee to take the necessary actions when the Chairman and President is notified by the Audit Practice and Review Committee that it has identified significant issues with regard to the quality control system of a particular firm during its investigation (Paragraph 2 of Article 89-2-2). This amendment is aimed at enhancing the effective collaboration between the Quality Control Committee and the Audit Practice and Review Committee. Previously, the Chairman and President chaired the Quality Control Committee; however, following these amendments, a

Deputy President appointed by the Chairman and President of the JICPA will now chair the Committee (Paragraph 2 of Article 88-2).

10-2. Amendment of the Regulations of the Quality Control Committee

Quality control review reports and recommendation reports will now require the approval of the Chairman and President before issuance pursuant to Paragraph 1 of Article 2, and Article 6 of the revised Regulations of the Quality Control Committee. This revision took place in conjunction with amendment of the Constitution (effective August 11, 2005).

10-3. Amendment of Detailed Rules of the Quality Control Committee

Detailed Rules of the Quality Control Committee were revised on April 6, 2005 to establish the new position of Deputy Chief Reviewer in order to address administrative issues arising from the increased number of reviewers.

10-4. Amendment of the Quality Control Review Standards

The role of quality control review, established in the Quality Control Review Standards, was changed from "directional or educational" to one of "directional" in accordance with the amendment of the Constitution. This change was approved by the Council meeting held on July 20, 2005.

10-5. Amendment of the Quality Control Review Procedures

Based on quality control reviews conducted to date, and the findings and recommendations made in the course of monitoring by the CPAAOB since April 2004, the Quality Control Committee prepared necessary amendments to the Quality Control Review Procedures that were approved by the Council meeting held on July 20, 2005 in order to further enhance quality control reviews in the future. Following are the major amendments:

- a. Divide norms to be complied with when performing an audit into auditing norms and accounting norms (judgmental criteria). Before this revision, they were defined collectively as "auditing and accounting norms." In the course of quality control reviews, it is to be evaluated whether an audit is performed in compliance with these auditing norms. Where significant noncompliance is identified in an auditor's judgment of fair presentation when reviewing the process of forming an audit opinion, there should be an additional evaluation of the adherence to accounting standards;
- b. Ascertain the justification for an audit corporation having different, multiple policies and procedures in relation to quality control, and whether there is an intention to unify these policies and procedures, if applicable;

- c. Established the position of Deputy Chief Reviewer, and made revisions necessary to administer the Review Team by groups;
- d. Obtain copies of relevant materials and working papers that are necessary to describe findings in a sheet of finding records or essential to advance the examination, and file them in the review working papers;
- e. Revise the composition of review working papers and documents to be submitted by an audit firm in order to conform to the additions and revisions of the review tools;
- f. Revise the addressee, date and period of the review described in a quality control review report or a recommendation report when the reorganizations of reviewed audit firms took place or a joint audit firm becomes subject to quality control review.

10-6. Amendment of the Quality Control Committee Administration Manual

Provisions relevant to deputy chief reviewers and matters described in the annual report and the semi-annual report were revised on August 19, 2005 in order to reflect actual practice.

11. Development and Amendment of Review Tools

Based on the quality control reviews conducted to date and recommendations made in the course of monitoring by the CPAAOB since April 2004, review tools were added and revised on May 20, June 17, and July 12, 2005 in order to further enhance quality control reviews in the future and to respond to the expansion of review engagements in this review year and thereafter.

11-1. Amendment of audit firm profiles (QCQ100 – Audit corporations; QCQ110 – CPAs)

An amendment was made in relation to the expansion of review engagements this year.

Guidelines for completing profile data were moved to the last page.

11-2. Amendment of questionnaires about the quality control of an audit (QCQ200 – Audit corporations; QCQ210 – Details for an audit corporation; QCQ220 – CPAs)

- a. Improved consistency of questions among QCQ200, QCQ210, and QCQ220;
- b. Modified QCQ200 and QCQ210 which might have been interpreted as allowing different, multiple quality control policies and procedures, clarifying instead that uniform policies and procedures should be designed and implemented;
- c. Developed questions on the assessment of control risk associated with information systems using IT;
- d. Added questions of engagement quality control reviews for expressing an audit opinion to QCQ220 as well as the documentation as to entrusted matters when CPAs make use of

external persons to facilitate engagement quality control review, which has been implemented by the JICPA;

- e. Added questions on designated partners to QCQ200 and QCQ210;
- f. Added questions to ascertain that the person responsible for monitoring the implementation of quality control is not engaged in an audit and to illustrate the relationship between that person and an engagement quality control reviewer.

11-3. Amendment to the list of audit engagements subject to quality control review (QCQ300)

- a. Added a form for non-listed companies, such as non-listed large companies, corresponding to the expansion of the reviewed audit engagements;
- b. Added years of association of audit partners, audit fees, fees for non-audit services, and hours spent on an audit engagement;
- c. Added consolidated financial information, in addition to the non-consolidated information;
- d. Requested explanatory documents for the reasons of change of auditor, if due to audit risk or disagreement with an audit client;
- e. Requested a description that a reviewed audit client adopts accounting principles generally accepted in countries other than Japan or if listed on a foreign capital market, if applicable.

11-4. Amendment and addition of audit engagement profiles (QCQ400, QCQ480, and QCQ485)

- a. Requested a description of written confirmation of independence obtained from all personnel engaged in an audit;
- b. Requested a description of the number of CPE credit units obtained in the prior year by all personnel engaged in an audit;
- c. Requested a description of the hours spent on engagement quality control review during planning, the year's interim, and the year-end phases, respectively, and the dates of issuance of the auditor's report and management representation letter;
- d. Improved consistency between "III. Summary of significant matters considered in the course of an audit" and "2. Determination of significant items to be examined" of QCP400;
- e. Requested detailed information on comparatives of significant items such as financial statements and accounting estimates based on work papers to increase information included in the Appendix;
- f. Added audit engagement profiles for an independent administrative agency (QCQ480) and a national university (QCQ485) corresponding with the expansion of reviewed audit engagements.

11-5. Additions of review planning procedures (QCP100)

Procedures for planning a review and advanced preparation were added as QCP100. This addition caused the renumbering of the former QCP100 as QCP200, QCP200 as QCP300, and QCP300 as QCP400.

11-6. Amendment of procedures for interviews with personnel engaged in an audit (QCP300)

- a. Organized matters relating to the amended CPA Law;
- b. Added questions regarding independence.

11-7. Amendment and addition of audit engagement review procedures (QCP400)

- a. Clarified review procedures, matters to be noted, and the relationship with audit engagement profiles (QCQ400);
- b. Added procedures for changes of accounting policies (QCP416) and the percentage of completion method (ACP417);
- c. Added industry-specific review programs for banking (QCP450), general insurance (QCP460) and life insurance (QCP470), an independent administrative agency (QCP480) and a national university (QCP485) corresponding with the expansion of reviewed audit engagements.

11-8. Addition of sheets of findings (QCF120 and QCF130)

Sheets of findings (QCF120 and QCF130) were added on December 16, 2005 and February 17, 2006 to describe findings and an engagement partner's or joint auditor's views regarding necessary corrective actions.

Revised quality control review tools are sold to members and associate members in the form of CD-ROMs or bound volumes. Review tools are also scheduled to be revised in 2006.

12. Activities of the Quality Control Committee and review working groups

Further to the increase in members of the Quality Control Committee on August 1, 2005, Deputy President Koichi Masuda assumed the Chair of the Committee on August 25, 2005 as Deputy President named by the Chairman and President, pursuant to the revised Constitution that took effect on August 11, 2005. Before this revision, the Chairman and President was assigned that position.

The table below indicates the number of meetings of the general committee and review working groups of the Quality Control Committee. Until July 31, 2005, the general committee consisted of the Chair and 16 members. The general committee was composed of the Chair and 26 members from

August 1, 2005, and subsequently, the Chair and 25 members from August 25, 2005. Until July 31, 2005, review working groups consisted of three groups, but this expanded to five groups on August 19, 2005. Each group is composed of five members. A working group for independent administrative agencies was established on April 28, 2005 in order to develop review tools for independent administrative agencies, local independent administrative agencies, and national universities, which are included within the scope of quality control reviews for years ended March 31, 2006 and thereafter, and to provide reviewers with necessary instructions for the review of these organizations. This working group consists of the Chair and one member.

	Number of meetings held
General committee	17
Review working groups	76
Working group for independent administrative agencies	1

13. Quality Control Review Team

To address expansion in the scope of quality control reviews, the number of reviewers increased by eleven, compared with the previous year. Pursuant to the Detailed Rules of the Quality Control Committee (as amended), two deputy chief reviewers were appointed in newly created positions as of July 1, 2005 in order to effectively manage the increased number of reviewers. The composition of the quality control review team as of March 31, 2006 is as follows:

	Number of staff
Chief reviewer	1
Deputy chief reviewers	2
Senior reviewers	10
Staff reviewers	7
Total	20

The total number of days spent on reviews conducted by reviewers is as follows:

	Year ended March 31, 2005	Year ended March 31, 2006
Audit corporations	872	2,073

Sole practitioners	253	462
Total	1,152	2,535

The total number of days spent on reviews this year has increased a great degree due to the expansion of the scope of quality control reviews.

14. Future Challenges of the Quality Control Review System

It has been two years since the amendment of the CPA Law requiring the CPAAOB to monitor the quality control review system. The Quality Control Committee sincerely has accepted recommendations from the CPAAOB and the Quality Control Oversight Board, and made every effort to implement necessary reforms and to enhance the effectiveness of quality control reviews.

The role of the quality control review system as a self-regulatory function of the JICPA has been more important than ever before as the infrastructure for the sound development of audits in Japan, under circumstances such as the series of accounting frauds that have taken place and resulting administrative actions that were imposed. The Quality Control Committee acknowledges these situations, and will maintain and improve the quality of audits performed by JICPA members to meet public expectations by conducting effective and rigorous quality control reviews.

Issues related to the quality control review system that need to be addressed in the future include the following:

14-1. Ascertainment of the readiness of audit firms to meet Standards on Quality Control for Audits and related guidance for implementation (collectively referred to as "Standards of Quality Control"):

- Whether audit firms appropriately establish a firm-wide system of quality control in accordance with the Standards of Quality Control that apply to financial statement audits for periods beginning on or after April 1, 2006. Those audit firms that have not fully implemented such systems are encouraged to do so.

14-2. Ensuring full implementation of corrective actions by strengthening follow-up measures of recommendations:

- Although some progress has been observed in each audit firm in implementing quality control of audits, repeated issues are continually being identified. When implementation of corrective action is considered unsatisfactory after reviewing the report submitted by an audit

firm on implementation of quality control, the Review Team will visit the audit firm and provide instructions to promote improvements.

- When some issues are identified in the report on implementation of quality control submitted by an audit firm of which a quality control review has not been conducted, the quality control review of such an audit firm will be scheduled to occur sooner.

14-3. Improvement in the reviewing quality level of quality control reviews based on past performance

- a. Consistency with the Quality Control Standards in policies and procedures as determined by audit firms:
 - Whether audit firms update their audit manuals, checklists, and other materials to enhance auditing practices using a new risk-based approach, applicable for periods beginning on April 1, 2006 and thereafter;
 - Whether audit firms instruct their engagement teams to identify risk factors related to misstatements and to focus on high risk areas;
 - Whether audit firms properly respond to accounting estimates, unusual transactions, and going concern assumptions;
 - Whether audit firms take appropriate actions when assessing control risks in relation to information systems using IT.
- b. Compliance with policies and procedures of quality control determined by audit firms:
 - Whether audit firms try to improve actual auditing practices through proper risk assessment, and document these practices in relation to implementation of the risk-based approach;
 - Whether audit firms conduct internal quality control monitoring adequately and promote improvement of audit quality.

14-4. Special quality control reviews for cases reported to the Chairman and President by the Audit Practice and Review Committee

- With regard to the cases reported to the Chairman and President by the Audit Practice and Review Committee and for which the Chairman and President provides directions to the Quality Control Committee pursuant to Paragraph 2 of Article 89-2-2 of the Constitution, an appropriate response should be implemented on an individual case basis. Especially for audit firms or audit engagements not subject to quality control review, the Committee will make the necessary responses after careful consideration regarding the scope of special quality control reviews.

As steps to improve the quality of audits, the JICPA is now discussing the establishment of a "the Center for Listed Company Audit Firms" (tentative name) under the auspices of the Quality Control Committee, and specific measures concerning the introduction of a registration system for audit firms of listed companies. If the introductions of these specific measures are resolved by amendments of the Constitution at the Special Assembly this autumn, the Quality Control Committee will need to take new action. Careful preparation in the establishment of this robust system is also an important issue for maintaining the quality control review system as a self-regulatory body.